

IMF Executive Board Concludes 2012 Article IV Consultation with Tonga

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On May 16, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Tonga.¹

Background

Tonga's economy is recovering gradually from the effects of the global slowdown and the domestic credit crunch, thanks to the pickup in construction activity and rebound in tourism. However, private consumption has been anemic due to the decline in remittance inflows. In addition, banks' lending standards have remained tight, constraining private consumption and investment. Real GDP growth is forecast to be around 1½ percent in FY2011/12, led by stronger tourism activity and a continued fiscal stimulus funded by donor aid and previously contracted concessional loans.

CPI inflation declined to 2½ percent year-on-year in February 2012, reflecting mainly stabilization in fuel and food prices as well as exchange rate appreciation. Inflation is likely to average around 4½ percent in FY2011/12.

The fiscal position has strengthened but vulnerabilities remain. Generous grant inflows from donors contributed to narrowing the fiscal deficit to an estimated 2¾ percent of GDP in 2011/12 (from about 6 percent of GDP in FY2010/11). Capital expenditure is expected to be lower by 2 percentage points of GDP due to the completion of the reconstruction of the central business district and near completion of the road projects using the Export-Import Bank of China (China EXIM Bank) loans. Nevertheless, Tonga remains at a "high risk of external debt distress" according to this year's World Bank-IMF debt sustainability analysis.

Buoyant official development assistance helped improve the balance of payment position, which allowed the National Reserve Bank of Tonga (NRBT) to let the currency appreciate by 6 percent against the US\$ and real effective terms in 2011 to help curb inflation pressures stemming from rising fuel and food import prices. The level of reserves increased to around \$130 million as of end-2011, covering more than 6 months of imports of goods and services.

Monetary conditions have remained accommodative over the past two years, but with no signs of a pickup in private credit. Monetary policy has been appropriately geared toward encouraging bank lending. The banking system is adequately capitalized and profitable but credit costs related to the rise in non-performing loans (NPLs) following the 2004-08 credit bubble remain high; and banks have continued to restrain credit amidst an uncertain outlook.

Executive Board Assessment

Executive Directors welcomed Tonga's recovery from the global crisis but noted remaining vulnerabilities and a high debt burden. With downside risks clouding the outlook, Directors emphasized the importance of strengthening policy buffers and the foundation for faster and more inclusive growth.

Directors concurred that fiscal consolidation is needed to rebuild the government's cash balances and safeguard debt sustainability. Accordingly, containing the public sector's wage bill, prioritizing expenditures, and broadening the tax base remain top policy priorities for the period ahead. More broadly, Directors encouraged the authorities to implement their fiscal plans within a medium-term framework and further improve the quality of public spending to meet Tonga's development objectives.

Directors considered the current accommodative monetary policy stance appropriate in light of the banks' cautious approach to lending. Taking note of the staff's assessment that the exchange rate is broadly in line with fundamentals, Directors agreed that, going forward, the exchange rate could absorb the bulk of external shocks with official intervention limited to smoothing operations.

Directors supported steps underway to reduce credit risk and strengthen financial intermediation. They welcomed recent legislation to improve the registration of collateral and recommended further financial sector reforms such as establishing a centralized credit bureau, facilitating land leases, and enacting a bankruptcy law. Directors also urged the authorities to continue to resist pressure to administer bank lending rates.

Directors underscored the importance of removing structural hurdles to private investment and reducing the cost of doing business, including through public enterprise reforms. Steps in this direction would lay the groundwork for broadening the production base and reducing poverty.

Tonga: Selected Economic Indicators, 2007/08–2012/13 1/

				Prelim.	Proj.	
	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
	(Annual percent change)					
Output and prices						
Real GDP 2/	1.1	0.0	1.9	1.4	1.6	1.2
Consumer prices (period average)	9.6	5.5	1.7	6.1	4.6	4.5
Consumer prices (end of period)	12.2	1.2	2.7	7.9	3.0	6.0
GDP deflator	7.9	-1.2	3.7	7.1	4.3	6.4
	(In percent of GDP)					
Central government finance						
Total revenue and grants	25.8	34.6	27.0	27.1	26.0	30.6
Total revenue	24.4	27.7	20.7	20.2	18.8	19.0
Grants	1.3	6.9	6.3	6.9	7.2	11.6
Total expenditure and net lending	24.3	34.8	33.0	33.0	28.7	30.0
<i>Of which:</i> Current expenditure	23.8	25.5	27.7	23.7	21.2	25.5
Capital expenditure	0.5	6.1	4.0	7.8	5.8	4.5
Overall balance	1.5	-0.2	-6.0	-5.9	-2.7	0.6
Overall balance (excl. China's EXIM Bank loans)	...	5.5	-1.8	1.6	3.3	1.2
External financing (net)	0.2	5.5	3.6	6.8	5.2	-0.3
Domestic financing (net)	-1.7	-5.3	2.5	-0.9	-2.5	-0.3
	(Annual percent change)					
Money and credit						
Total liquidity 3/	8.2	-1.8	5.1	3.1	5.4	7.5
<i>Of which:</i> Broad money (M2)	9.2	-2.4	5.6	3.3	5.9	7.7
Domestic credit	13.9	-5.2	-11.5	-12.3	-3.8	8.9
<i>Of which:</i> Private sector credit	17.1	-3.7	-15.6	-9.9	0.9	5.2
Interest rates (end of period)						
Average deposit rate	5.7	4.9	3.4	3.4

Base lending rate	10.0	10.0	9.6	9.6
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(In millions of U.S. dollars)

Balance of payments

Exports, f.o.b.	8.3	7.2	7.9	10.9	11.7	12.4
Imports, f.o.b.	-142.2	-	-	-	-184.5	-
		130.5	130.4	152.5		184.7
Services (net)	-13.3	-15.2	-8.5	6.7	4.2	4.3
Investment income (net)	7.5	6.4	4.0	10.2	11.6	11.7
Services and investment income (net)	-5.8	-8.8	-4.5	16.9	15.8	16.0
Current transfers (net)	114.2	104.0	102.7	118.6	128.5	145.1
<i>Of which: Remittances</i>	106.7	84.0	82.0	87.5	91.9	96.5
<i>Of which: Official grants</i>	3.7	17.5	18.2	22.8	28.0	39.8
Current account balance	-25.6	-28.1	-24.2	-6.1	-28.6	-11.2
(In percent of GDP)	-7.3	-8.9	-6.7	-1.5	-6.1	-2.3
Current account balance (excl. imports related to China EXIM Bank loans)	-25.6	-19.6	-15.5	14.2	-11.1	-9.0
(In percent of GDP)	-7.3	-6.2	-4.3	3.4	-2.4	-1.9
Overall balance	1.2	19.5	20.9	32.0	3.5	12.3
Terms of trade (annual percent change)	-1.7	-5.3	5.9	-5.1

Gross official foreign reserves

In millions of U.S. dollars	48.2	67.7	88.7	120.7	124.2	136.6
(In months of next year's goods and services imports)	3.2	4.6	5.1	5.7	5.9	6.2

External debt (in percent of GDP)

External debt	24.8	31.9	33.3	36.3	40.8	39.4
Debt service ratio	1.4	0.8	1.3	1.2	1.3	1.5

Exchange rates

Pa'anga per U.S. dollar (period average)	1.9	2.1	1.9	1.8
Pa'anga per U.S. dollar (end of period)	1.8	2.0	1.9	1.7
Nominal effective exchange rate	92.1	95.6	96.8	97.4

(1990=100)

Real effective exchange rate (1990=100)	101.1	107.5	108.3	111.5
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Memorandum items:

Remittances (in percent of GDP)	30.5	26.7	22.8	21.3	19.7	19.9
Tourism (in percent of GDP)	6.3	8.8	7.2	8.1	8.5	8.6
FDI (in percent of GDP)	4.2	6.1	5.3	1.8	1.7	1.7
Nominal GDP (millions of T\$)	664.8	656.8	694.1	753.5	798.2	859.4
Gross Disposable Income (millions of T\$)	868.9	840.3	852.4	937.4	982.9	1077.3
Population (thousands)	102.4	102.9	103.3	103.7	104.1	104.6

Sources: Data provided by the Tongan authorities; and IMF staff estimates and projections.

1/ Fiscal year beginning July.

2/ Including preliminary data.

3/ From the *Banking Survey*, which includes the Tonga Development Bank.

¹ Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: <http://www.imf.org/external/np/sec/misc/qualifiers.htm>.

IMF EXTERNAL RELATIONS DEPARTMENT

Public Affairs

Media Relations

E-mail: publicaffairs@imf.org

E-mail: media@imf.org

Fax: 202-623-6278

Phone: 202-623-7100